United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

ORIGINAL

Consolidated Appeals:
77-5019, 77-5022

77-5019

United States Court of Appeals

For the Second Circuit

UNITED STATES COURT OF APPEALS
FILED
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SECOND CIRCUIT

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P/S

In the Matter of

STIRLING HOMEX CORPORATION, *Debtor*

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY, HARRY E. JONES, ALECK GOLDBERG, as Custodian for Mark Goldberg, and MRS. D. WINDSOR DIXON,

Appellants.

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MANHATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF CHICAGO; MARINE MIDLAND BANK; THE TRAVELERS INDEMNITY COMPANY; and THE SECURITIES AND EXCHANGE COMMISSION,

Appellees.

Appeal from the United States District Court for the Western District of New York

PETITION FOR REHEARING AND SUGGESTION FOR REHEARING IN BANC

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket Nos. 77-5019, 77-5022

In the Matter of

STIRLING HOMEX CORPORATION,

Debtor.

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY, HARRY E. JONES, ALECK GOLDBERG, as Custodian for Mark Goldberg, and MRS. D. WINDSOR DIXON,

Appellants,

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MANHATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF CHICAGO; MARINE MIDLAND BANK; THE TRAVELERS INDEMNITY COMPANY; and THE SECURITIES AND EXCHANGE COMMISSION,

Appellees.

PETITION FOR REHEARING AND
SUGGESTION FOR REHEARING IN BANC

Claimant-appellants, defrauded stockholders of the debtor corporation, respectfully pray for rehearing of their appeal pursuant to FRAP 40. Because of the exceptional importance and novelty of the question presented, rehearing in banc is suggested pursuant to FRAP 35.

The Court's decision affirms a district court ruling in a Chapter X reorganization that creditors' claims arising out of purchases of the debtor's stock are to be subordinated to claims of all other creditors solely because the subordinated creditors are or once were stockholders of the debtor. This result, undirected by any provision of the Bankruptcy Act, is held to be a fair and proper exercise of the equitable power of the bankruptcy court.

The debtor is insolvent. Hence the decision leaves the stockholder creditors entirely without participation in the debtor's assets.

STATEMENT OF THE CASE

The debtor, Stirling Homex Corporation, filed under Chapter X of the Bankruptcy Act soon after large quantities of its shares were sold to the investing public. As noted by the Court on a related appeal, U.S. v. Stirling, 571 F. 2d 708, 713-4 (2d Cir. 1978), key officials of the corporation "engaged collectively in a calculated and multifaceted plan to give the

investing public the false impression that Homex was in a sound and steadily improving financial position and at the same time withhold adverse information that was material to an accurate appraisal of the company's prospects." The merit of appellants' fraud claims, while questioned in the court below, is conceded in this Court's opinion herein, from which the passage just quoted has been extracted (slip op. p. 3518).

The Trustee has concluded that the debtor is unable to continue operations; he has been engaged in liquidating its assets, as he may under Chapter X,* for distribution to creditors. The distributable assets amount to $17 million against claims of $46 million, excluding those of the defrauded stockholders which are difficult to estimate but could run as high as $100 million.

The foregoing appears from the Court's opinion herein. A further record fact, not alluded to in the opinion but stressed in appellants' briefs, is that $37 million of claims, on the part of the debtor's bankers, arose from loans to the debtor which were made when the debtor's equity capital was a mere $8.5 million, before $20 million of the debtor's preferred stock was sold to the public.

GROUNDS FOR REHEARING

1. The decision improperly lays down, in the guise of an exercise of equity jurisdiction, a new and absolute rule

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* See Bankruptcy Act, § 216(10), 11 U.S.C. § 616(10); Central States Electric Corp. v. Austrian, 183 F. 2d 879, 883 (4th Cir. 1950), cert. den. 340 U.S. 917 (1951); Bankers Life and Casualty Company v. Kirtley, 338 F. 2d 1006, 1009-10 (8th Cir. 1964).

subordinating all claims of creditors which arise out of purchases of the debtor's stock. Equitable subordination is warranted only where the subordinated claimant has been guilty of specific misconduct, to the injury of the debtor or its other creditors. In this case the subordinated claimants are entirely innocent of any such misbehavior.

2. In relying on a bill to subordinate stockholders' fraud claims, which so far has passed only the House of Representatives, the Court's decision in effect is enacting legislation in advance of Congress.

1.

BLANKET SUBORDINATION OF FRAUD CLAIMS OF PAST AND PRESENT STOCKHOLDERS IS A NEW AND FAR-REACHING DOCTRINE, WITHOUT SUPPORT IN THE BANKRUPTCY ACT OR IN THE PRINCIPLE OF EQUITABLE SUBORDINATION ON WHICH THE PRESENT DECISION IS RESTED.

Appellants (and other similarly situated claimants) clearly fall within the definition of "creditor" in § 106 of the Bankruptcy Act, 11 U.S.C. § 506. This was recognized by the district court and is assumed by this Court for purposes of its decision (slip op. pp. 3525-6). The Act does not discriminate among unsecured or general creditors according to the manner in which their claims arose. 6A Collier on Bankruptcy, ¶ 9.13, p. 238; In re Palisades-On-The Desplaines, 89 F. 2d 214, 217 (7th Cir. 1937); Scherk v. Newton, 152 F. 2d 747, 750-51 (10th Cir. 1945). Nor has the absolute priority rule (slip op. pp.

3523-4) ever been held to apply to other than the equity interests of present stockholders.

The Supreme Court has addressed the problem of fraud claims arising from stock purchases on only one occasion, in Oppenheimer v. Harriman National Bank & Trust Co., 301 U.S. 206 (1937). The Court found no inequity in parity treatment of such claims (at p. 215):

> "And as claimants they [i.e., stockholders] stand on the same footing as other creditors. Discrimination against their claims is not authorized by the statute [i.e., National Bank Act]." [bracketed matter interpolated; footnote omitted.]

This Court, in the decision at bar, agrees with the district judge that parity treatment of stockholders' fraud claims would defeat the normal expectations of other general creditors of publicly held companies. It can be said with equal logic that subordination of such claims (equivalent to extinction, in this and most other Chapter X reorganizations) would defeat the fair expectations of investors who otherwise enjoy the protection of federal and state securities laws. Assuming, however, that the Court's decision correctly ranks the supposed policy of Chapter X over the policy of the federal securities laws (slip op. p. 3532), the Bankruptcy Act nowhere allows subordination of otherwise valid claims on any such ground. Nor, until the decision in question, has any appellate court nullified shareholders' fraud claims on such a premise.

None of the cases cited at pages 3528-9 of the slip opinion begins to sanction classification of claims in a Chapter X reorganization for any such policy or other generalized reasons.

The Court's novel ruling is said to be well grounded in the bankruptcy judge's broad equity powers. But those powers, under settled case law, are circumscribed by well-defined standards. Notwithstanding his equity powers, the bankruptcy judge may not classify creditors according to the length of his foot - nor, according to his social and economic predilections as to the consequences of parity treatment.

Rather, the doctrine of equitable subordination in bankruptcy and reorganization law is a device for denying equal treatment to creditors because of particular inequitable or fraudulent acts or transactions in which they have engaged, to the detriment of the debtor or its other creditors. In re Credit Industrial Corp., 366 F. 2d 402, 408-9 (2d Cir. 1966); In the Matter of Mobile Steel Co., 563 F. 2d 692, 698-702 (5th Cir. 1977); In re Four Seasons Nursing Centers of America, Inc., 483 F. 2d 599, 602-3 (10th Cir. 1973); 3A Collier on Bankruptcy, ¶ 63.08; 6 (Part 2) Id., ¶ 9.15. Mobile Steel is especially enlightening on this crucial point, exploring it in depth with a profuse review of the authorities.* In reversing for lack of evidence of inequitable conduct a decision to subordinate

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* Regrettably Mobile Steel, decided November 21, 1977, came to our attention too late for citation in appellants' briefs.

claims of insiders against the debtor, the Fifth Circuit held (at p 699-700):

> "The prerogative to relegate claims to inferior status on equitable grounds, though broad, is not unlimited. It confronts two principal bounds. First equitable consideration can justify only the subordination of claims, not their disallowance. ***
>
> * * * * *
>
> *"Second, three conditions must be satisfied before exercise of the power of equitable subordination is appropriate.*
>
> *(i) The claimant must have engaged in some type of inequitable conduct.*
> *(ii) The misconduct must have resulted in injury to the creditors of the bankrupt and conferred an unfair advantage on the claimant.*
> *(iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act."* [italics added; citations omitted.]

Needless to say not one, let alone all, of these requirements is met in this case.

Moreover, on the record so far made in this case the preferred stockholder-creditors should be ranked with, rather than beneath, the bank creditors - according to the Slain & Kripke article, "The Interface Between Securities Regulation and Bankruptcy - Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors," 48 N.Y.U.L.R. 261 (1973), relied on in the decision at bar (slip op. p. 3530). Slain & Kripke distinguish between

claimants who extended credit to the debtor before the defrauded stockholders made their investment, as against those who extended credit later so as to be able to claim reliance on an "equity cushion" (48 N.Y.U.L.R. at 289):

> "If reliance is to be the touchstone between creditor and rescinding stockholder, a distinction should be drawn between credit obligations incurred before and after the stockholder's investment. An occasional case may arise in which a prior creditor can demonstrate that he later changed his position in reliance on the stockholder's investment. For example, a creditor may release a security interest, renew a term loan or waive an event of default upon learning of an apparent improvement in the debtor's equity position. In general, however, it is unlikely that a prior creditor will be able to show even derivative reliance. Consequently, while subsequent creditors should be presumed to have relied on the rescinding stockholder's investment, prior creditors should be required to sustain the burden of proving their detrimental reliance."

In our case the bank creditors lent $37 million to the debtor without security before the debtor's preferred stock was sold to the public for $20 million, at a time when the debtor's capital was a mere $8.5 million and only one year before reorganization; Appellants' main br., Pt. II. At the very least, therefore, under Slain's & Kripke's reasoning, the claims of the preferred stockholder-creditors should be ranked with $37 million of the bank debt.

THE DECISION IS IMPERMISSIBLE JUDICIAL LEGISLATION

The proposed legislation discussed at pages 3531-2 of the slip opinion assumes that a claim "arising from a purchase or sale of a security of the debtor" ranks with other general claims.* The bill, which has passed only the House of Representatives (slip op. p. 3531), would mandate the subordination of such claims.

The Court (slip op. 3531-2) assigns, in support of its decision, the arguments urged on Congress in support of the pending bill. Those points are properly before the Congress; but they have no place, we respectfully submit, in the judicial resolution of the present problem.

The Court should leave it to, and not anticipate, Congress by legislating in this area.

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* The Report on H.R. 8200 of the House Committee on the Judiciary, H.R. Rep. No. 95-595, 95th Cong., 1st Sess., pp. 194-5 (1977), cites Oppenheimer v. Harriman National Bank & Trust Co., supra, 301 U.S. 206, 214-5 (1937), as dramatically changing the law in favor of parity treatment.

CONCLUSION

For the foregoing reasons the petition for rehearing and the suggestion of rehearing in banc should be granted.

Dated: New York, New York
June 30, 1978

Respectfully submitted,

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Robert B. Block,
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Affidavit of Service by Mail

In re:

Gregory Jezarian, et al, v. Frank G. Raichle, et al.

State of New York
County of New York, ss.:

Gerald Green,

being duly sworn, deposes and says, that he is over 18 years of age.

That on JULY 3RD, 1978, he served 2 copies of the within Petition for Rehearing in the above-named matter on the following counsel by enclosing said three copies in a securely sealed postpaid wrapper addressed as follows:

Johnson, Reif and Mullan, P.C.
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Reorganization Trustee)

Nixon, Hargrave, Devans & Doyle, Esqs.
Lincoln First Tower
Rochester, New York 14603
(Attorneys for Appellee Lincoln First Bank of Rochester)

and depositing same in the official depository under the exclusive care and custody of the United States Post Office Department within the City of New York.

and depositing same at the Post Office located at Howard and Lafayette Streets, New York, N. Y. 10013.

Gerald Green

Sworn to before me this 3RD
day of JULY, 1978

Jack A. Messina

JACK A. MESSINA
Notary Public, State of New York
No. 30-2673500
Qualified in Nassau County
Cert. Filed in New York County
Commission Expires March 30, 1979

Affidavit of Service by Mail

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State of New York
County of New York, ss.:

Gerald Green,

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Marvin E. Jacob, Esq.
Associate Regional Administrator
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26 Federal Plaza
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and depositing same at the Post Office located at Howard and Lafayette Streets, New York, N. Y. 10013.

Gerald Green

Sworn to before me this 3RD day of July, 1978

Jack A. Messina

JACK A. MESSINA
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(Attorneys for Appellee Marine Midland Bank)

and depositing same in the official depository under the exclusive care and custody of the United States Post Office Department within the City of New York.

and depositing same at the Post Office located at Howard and Lafayette Streets, New York, N. Y. 10013.

Gerald Green

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